

Overview of the Governor's December 2010 Special Session Proposals

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On December 6, 2010, Governor Schwarzenegger declared a fiscal emergency pursuant to Proposition 58 (2004) and called the new Legislature into special session to address the anticipated 2010-11 General Fund deficit—estimated by our office at \$6.1 billion in our November 10 publication, *California's Fiscal Outlook*. Proposition 58 contains provisions to encourage the Legislature to pass measures addressing the fiscal emergency within 45 days (in this case by January 20, 2011). Prior to January 20, however, the new Governor will be inaugurated and present his proposed 2011-12 budget package, as well as an updated estimate of the size of the General Fund budget problem for 2010-11 and 2011-12. This special session is the first for the Legislature under the

rules of Proposition 25 (the majority-vote budget measure) approved by voters last month. It is also the first to occur following the passage of Propositions 22 and 26, which, respectively, restrict the Legislature's ability to use certain local funds to balance the budget and require a two-thirds vote to approve many charges that were previously considered fees.

This brief overview is divided into two sections: (1) a summary of the Governor's special session proposals—which consist mainly of proposals made by this administration earlier this year—along with our overall reactions to the proposals, and (2) a description of the major new proposal in the package, which would use vehicle weight fees to offset General Fund debt-service costs.

THE SPECIAL SESSION PROPOSALS

Governor Proposes \$9.9 Billion of Budget Actions for Next 18 Months

Proposals Would Reduce Near-Term Budget Problem Significantly. As shown in Figure 1 (see next page), the Governor's special session proposals would decrease the gap between General Fund revenues and expenditures by \$1.9 billion in 2010-11 and by \$8 billion in 2011-12, thereby

reducing the \$25.4 billion budget problem that we have identified to \$15.5 billion. This \$15.5 billion remaining budget problem—to be addressed by the Legislature and the administration in the next six months—would consist of a \$4.2 billion deficit at the end of 2010-11 and an \$11.3 billion gap between projected revenues and expenditures in 2011-12. (These estimates may change

following the release of the new Governor’s budget forecasts on January 10, 2011.) The Governor’s plan assumes approval by the Legislature by January 1.

Governor’s Social Services, Health, and Child Care Proposals. The Governor’s \$9.9 billion of proposed budget solutions in 2010-11 and 2011-12 consist of \$7.4 billion of expenditure-related reductions (according to our categorization of the proposals). Essentially all of these proposals were rejected earlier this year by the prior Legislature. The Governor’s expenditure proposals rely almost exclusively on reductions

to health, child care, and social services programs. These include \$2.2 billion resulting from the proposed elimination of the California Work Opportunities and Responsibility to Kids (CalWORKs) program, \$1.4 billion from the proposed elimination of state-subsidized child care services, \$1.3 billion from various reductions and eliminations of services in the Medi-Cal Program, and \$900 million from reductions to county mental health funding.

Two Major Revenue Proposals. The special session package includes two major revenue proposals rejected earlier this year. First, the

Figure 1

General Fund Budget Solutions in Governor’s Special Session Package

Reduced Costs or Increased Revenues (In Millions)

	2010-11	2011-12
Expenditure-Related Solutions		
Eliminate CalWORKs program	\$110	\$2,086
Eliminate child care funding, except preschool	200	1,157
Implement various Medi-Cal cost containment measures, such as caps and copayments	6	996
Reduce county mental health realignment funds by 60 percent	301	602
Commit certain non-serious offenders to county jails	112	650
Reduce SSP grants for individuals to the federal minimum	45	182
Eliminate Medi-Cal adult day health care services	21	189
Eliminate Cash Assistance Program for Immigrants	29	124
Contract for lower-cost state employee and retiree health benefit costs	—	144
Eliminate full-scope Medi-Cal benefits for certain immigrants	15	120
Eliminate Drug Medi-Cal Program	18	93
Eliminate California Food Assistance Program	15	69
Implement various Healthy Families Program cost containment measures	9	43
Implement electronic court reporting to reduce judicial costs	7	13
Implement other cost reductions (net)	2	-4
Subtotals	(\$888)	(\$6,465)
Revenue Solutions		
Implement automated speed enforcement program to offset trial court costs	—	\$412
Levy property insurance surcharge for emergency response activities	—	350
Extend hospital fees to June 2011 to offset Medi-Cal costs	\$160	—
Subtotals	(\$160)	(\$762)
Funding Shifts		
Use weight fee revenues for transportation debt service costs	\$850	\$727
Implement other funding shifts	11	8
Subtotals	(\$861)	(\$735)
Totals, All Proposed Solutions	\$1,909	\$7,962

Governor proposes an automated speed enforcement program to offset trial court costs, thereby reducing General Fund expenses by \$400 million in 2011-12. Second, the Governor proposes a property insurance surcharge to offset CalFire and other emergency services costs, thereby reducing General Fund costs by an assumed \$350 million in 2011-12. Beginning in 2012-13, the Governor proposes to use at least some of the revenues from the surcharge to *enhance* emergency response activities.

New Transportation Proposal to Relieve General Fund Debt Service Costs. The administration's new weight fee "swap" proposal (described later in this report) would use these vehicle fees to pay \$1.6 billion of General Fund transportation debt-service costs over 2010-11 and 2011-12 combined.

Proposals Would Reduce Out-Year General Fund Shortfall Significantly. Our November 10 forecast estimated that the state faced a structural shortfall—a persistent gap between revenues and expenditures—of at least \$19.4 billion in each fiscal year through 2015-16. The Governor's special session proposals would involve permanent reductions in state spending or increases in revenues. Accordingly, the Governor's proposals—if they were all adopted—would significantly reduce this shortfall. Our very rough estimate is that the 2015-16 deficit would be reduced from \$19.4 billion to somewhere around \$12 billion. In our November 10 report, we recommended the Legislature chip away at the state's budget problems with \$10 billion in *permanent*—as opposed to temporary—budget solutions in 2011-12. Additional permanent solutions would need to be added in future years. The Governor's proposals would achieve the vast majority of this \$10 billion target.

LAO Comments on the Special Session Proposals

Now Is the Time to Begin Action on These and Other Serious Budget Options. The size of the budget problem to be addressed in the next six months is so large that lawmakers need to consider significant expenditure reductions in every major area of state expenditures—including the areas addressed in the Governor's special session proposals, as well as areas *not* addressed in his package, such as appropriations for the universities and courts. The Legislature also will need to consider additional revenue options. Early enactment of budget solutions makes it more likely that they can actually be achieved.

Many of the Governor's Proposals Have Merit. Our office has reviewed almost all of the special session proposals previously, as summarized in Figure 2 (see next page). Given the severity of the budget problem the state has faced recently, we have recommended that the Legislature adopt some of the Governor's major special session proposals. For other proposals, we have recommended scaled-down alternatives that aim to preserve the core services of programs. We will continue to refine our recommendations for the Legislature in the coming weeks. In some cases, the state will need to consider even greater expenditure reductions than we have recommended previously in some programs. In addition, the Legislature will need to consider temporary or permanent revenue increases to close the massive General Fund budget gap.

Help School Districts by Sending Signals Early. In our November 10 *California's Fiscal Outlook* publication, we noted that school and community college districts would face billions of dollars in programmatic reductions in

Figure 2

Prior LAO Analyses of Major Special Session Proposals

Special Session Issue	Prior LAO Comments	Prior LAO Publication With More Information
Elimination of CalWORKs	Recommended achieving reductions in costs, but avoiding loss of federal funding and shifting of costs to counties that would result from total program elimination. (Enhanced federal funding stream for CalWORKs expired in September 2010.)	<i>Overview of the May Revision</i> (May 18, 2010), p. 22.
Elimination of child care funding, except preschool	Recommended cost reductions, but not elimination of funding for the program.	<i>Handout: Options for Generating Savings in Child Care Budget</i> (June 14, 2010).
Place certain non-serious offenders sentenced to three years or less in county jails, not state prisons	Recommended modifying administration proposal to change offenders affected, lessen burden on county jails, and provide counties with more flexibility.	<i>Handout: Governor's May Revision Proposal to Shift Certain Offenders to County Jails</i> (May 26, 2010).
Reduce SSP grants for individuals to the federal minimum	Recommended adopting Governor's proposal and explore options for increasing food stamp assistance for low-income individuals to offset some of these reductions.	<i>How the Special Session Actions Would Affect Social Services</i> (January 29, 2010), p. 7.
Eliminate Cash Assistance Program for Immigrants and California Food Assistance Program	Recommended achieving part of the proposed savings by making changes prospectively, phasing out benefits gradually, or conditioning benefits on progress toward citizenship.	<i>How the Special Session Actions Would Affect Social Services</i> (January 29, 2010), p. 12.
Shift county mental health realignment funding to social services programs	Raised concerns whether the proposal could be implemented due to Proposition 63 maintenance-of-effort requirements.	<i>Website Analysis: "Mental Health Realignment Risky"</i> (May 19, 2010).
Various Medi-Cal cost containment measures—including copayments and "hard caps" on benefits	Recommended alternatives to several administration proposals, including exceptions to a cap on adult physician visits and lower copayments in some cases.	<i>Website Analysis: "Medi-Cal Cost Containment Proposals"</i> (May 20, 2010).
Eliminate full-scope Medi-Cal benefits for certain immigrants	Recommended adoption of Governor's proposal to eliminate full-scope benefits for certain immigrants, while continuing emergency and other services such as long-term care for these groups.	<i>How the Special Session Actions Would Affect Health Programs</i> (January 22, 2010), p. 5.
Elimination of Medi-Cal adult day health care services	Recommended adoption of Governor's proposal to eliminate the program. Direct administration to estimate costs from shift of eligible participants to other programs due to closure.	<i>How the Special Session Actions Would Affect Health Programs</i> (January 22, 2010), p. 4.
Elimination of Drug Medi-Cal, except for perinatal and youth services programs	Offered several alternatives to save lesser amounts of monies in this program, including copayments and some limits on individual and group counseling sessions.	<i>Website Analysis: "Options for Reducing Costs in the Drug Medi-Cal Program"</i> (December 6, 2010).
Automated speed enforcement	Recommended adoption of Governor's proposal with modifications to encourage local government participation.	<i>Automated Speed Enforcement Merits Authorization</i> (January 27, 2010).
Emergency Response Initiative—property insurance policy surcharge for CalFire and other emergency response	Recommended rejection of Governor's surcharge proposal and, in its place, the adoption of a wildland fire protection fee.	<i>The 2010-11 Budget: Resources and Environmental Protection</i> (March 8, 2010), p. RES-30.
Reduce state employee and retiree health costs by moving plan administration from CalPERS or by other means	Noted that while the proposal was worth considering, it was unlikely to produce savings within a one-year time frame.	<i>The Governor's Employee Compensation Proposals</i> (January 27, 2010), p. 7.

2011-12 under the Proposition 98 minimum funding guarantee. We encourage the Legislature to begin working now to give school districts early signals about the budgetary and programmatic framework they will be operating under in the coming fiscal year and beyond. In particular, districts would benefit from the earliest-possible notice of changes to their budgeted state funding. In November, we suggested that the Legislature consider eliminating the \$1.8 billion in K-14 payments deferred in the 2010-11 budget package until July 2011. If it were to do so now, districts would have the greatest possible time to react and avoid committing those funds to additional

spending. Acting now also would help minimize the magnitude of the programmatic cuts that districts could be required to make in 2011-12. In addition, a significant way to assist districts would be to retain existing flexibility provisions (most notably, continuing to make certain categorical funding flexible), extend some of those provisions (for example, to apply to the K-3 Class Size Reduction and Home-to-School Transportation programs), and explore new types of flexibility (such as removing restrictions on contracting out and priority and pay for substitute teaching positions).

WEIGHT FEE PROPOSAL

The administration's December special session package proposes to use vehicle weight fees to pay \$1.6 billion of General Fund transportation debt-service costs over 2010-11 and 2011-12 combined. Below, we provide background information about recent changes in state transportation financing, then outline and comment on how the Legislature could respond to these latest proposed changes.

Background

Transportation revenues come mainly from taxes on fuels and vehicle weight fees and are generally used for transportation purposes. Transportation programs also benefit by receiving funds from the sale of general obligation bonds. The debt service on these bonds has historically been paid by the state's General Fund. Recently, however, transportation funds have been used to reimburse the General Fund for some of the debt-service costs on certain transportation bonds. In addition, transportation funds have

been loaned to the General Fund to help alleviate the state's fiscal problems.

Fuel Tax Swap Increased Funds Available to Pay Debt Service. In March 2010, the Legislature enacted a "fuel tax swap" to provide the state with greater flexibility over the long run in how it uses taxes on fuels for the state's spending priorities. The fuel tax swap changed the way the state taxes fuels in order to provide ongoing reimbursements to the General Fund for the payment of debt service on transportation bonds. Prior to passage of this legislation, the state charged an 18 cents per gallon excise tax on gasoline and diesel fuel. The state also charged a 6 percent sales tax on the purchase of these fuels. A major provision of the fuel tax swap was for the state to stop charging a sales tax on gasoline, and instead impose an additional excise tax (17.3 cents per gallon in 2010-11) on gasoline to generate an amount equivalent to what would have been collected from the sales tax. This is because the state has more flexibility to use excise tax revenues to help the General Fund condition. The

legislation did not change the total amount of transportation revenues collected by the state.

The fuel tax swap along with other actions adopted in the *2010-11 Budget Act* would have provided the state with \$1.6 billion in General Fund relief in the current year. Specifically, in the budget plan, \$491 million was to be used to reimburse the General Fund for highway and road debt service, and \$762 million was to be loaned to the General Fund. In addition, the budget plan included reimbursements for transit debt service amounting to \$287 million. Various transportation funds amounting to \$109 million were also to be loaned to the General Fund.

Proposition 22 Increases the Current-Year Deficit. On November 2, 2010, the voters approved Proposition 22, a complex measure that made numerous changes to the state Constitution and to the way transportation funds are allocated. This measure has an immediate impact on the state's fiscal situation. Specifically, the state is no longer allowed under Proposition 22 to use fuel tax revenues to reimburse the General Fund for transportation debt service. Similarly, borrowing of fuel tax funds is also prohibited. This has the immediate impact of increasing the current-year budget deficit by roughly \$900 million.

Proposition 26 Reduces State Flexibility. At the November 2010 election, voters also passed Proposition 26. Among other things, this measure could be interpreted—as we assumed in our recent fiscal forecast—to repeal the fuel tax swap effective November 3, 2011, and return the state to taxing fuels as it did prior to the passage of the swap. While the full impact of Proposition 26 is still unclear, it is likely that the state will lose flexibility in how it uses transportation funds and that the allocation of transportation funds for various purposes would change significantly.

Governor's Special Session Proposal

Use Vehicle Weight Fees for General Fund Relief. The Governor's December special session package proposes to transfer vehicle weight fee revenues to the General Fund. This would achieve an estimated \$850 million in budget solutions in 2010-11 and \$727 million in 2011-12 by reimbursing the General Fund with weight fee revenues for certain transportation bond debt service costs, and also loaning a portion of the weight fee revenues to the General Fund. Under the proposal, the fuel tax revenues that would have helped the General Fund prior to Proposition 22 would now be available for transportation programs.

LAO Recommendations

Overall, we think the Governor's proposal is reasonable and could achieve the level of savings proposed. Because of the complexity of the state's system for funding transportation, we propose that the Legislature take a two-step approach regarding the use of transportation funds to help the state's fiscal condition. First, we recommend the Legislature adopt during the special session the Governor's proposal and an additional General Fund solution we describe below to achieve total estimated General Fund savings of \$900 million. Second, we recommend that the Legislature develop and enact comprehensive legislation to address the use of transportation funding in the future.

Maximize General Fund Benefit in the Short Term. Changes made to the Constitution by Proposition 22 do not explicitly prohibit the use of weight fees for the payment of debt service or General Fund loans. While Proposition 22 will likely be subject to judicial interpretation, we think the Governor's approach is reason-

able. The amount of General Fund benefit of the Governor's proposal could be increased by about \$50 million. That is because the state will collect an estimated total of \$900 million from weight fees in 2010-11. Given the state's severe budget problem, we recommend adopting the Governor's proposal and borrowing the remaining \$50 million in weight fees to help address the state's current General Fund deficit.

More Comprehensive Fix Needed for the Future. The Governor's weight fee proposal is only a short-term benefit to the state General

Fund. Assuming the fuel tax legislation is repealed by Proposition 26 in November 2011, there would no longer be sufficient fuel excise tax revenues to backfill for the weight fee revenue sent to the General Fund under the Governor's proposal without major programmatic impacts on transportation. A long-term solution to benefit the General Fund beyond this date would likely require the Legislature to reenact fuel tax swap legislation or other actions. We are continuing to analyze the components of a more comprehensive solution to these problems.

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